Internal Revenue Service

FS:CORP:GBFleming

date:

A 1991 NUA

to: District Counsel, Denver SW:DEN

Attention: Virginia Draper

from: Assistant Chief Counsel (Field Service) CC:FS

subject:

This responds to your memorandum dated July 31, 1991, requesting tax litigation advice with respect to the above-captioned case.

ISSUES

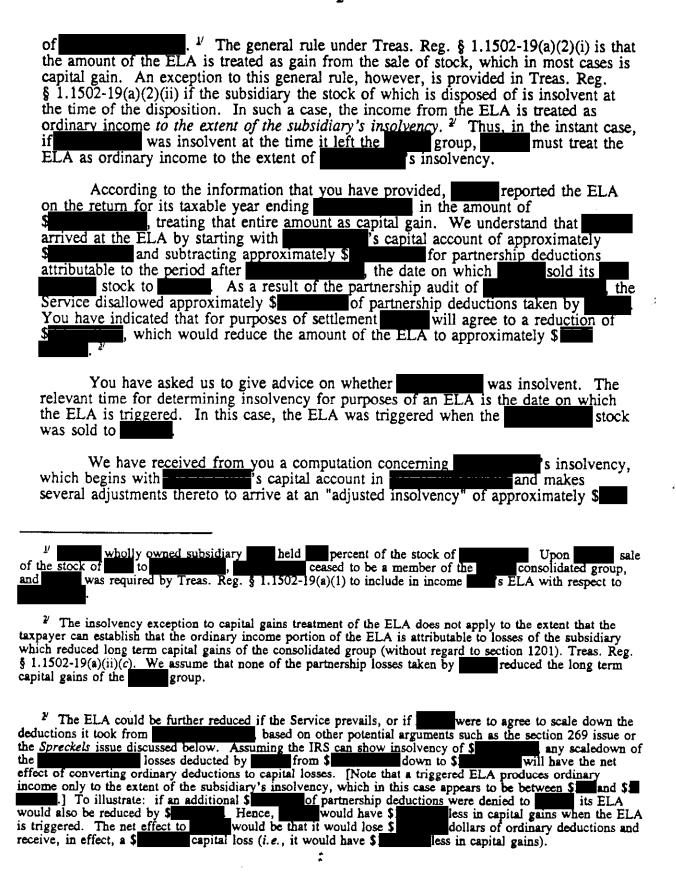
- 1. Can the Service make a case that is not entitled to report the excess loss account under Treas. Reg. § 1.1502-19 as capital gains, but rather must recognize the recapture as ordinary income because was insolvent?
- 2. Is the position that is not entitled to take any of the losses stemming because it was acquired for the principal from its acquisition of purpose of obtaining losses strong enough to litigate the issue?
- able to avoid gain on the acquisition of the building by the bank in by making a section 338 election?
- 4. If the case should go to litigation, can the corporate and TEFRA partnership issues be combined in one case, given that all partners in the TEFRA partnership action are parties to the suit?

DISCUSSION

The extensive facts involved in this case, as set forth in the defense letters and the government's brief (Attachments 1-5 to your memorandum), are incorporated by reference and will not be recited in full. The facts relevant to your request will be described briefly under the discussion of each issue.

I. Excess Loss Account

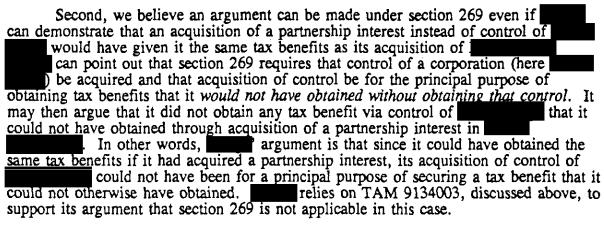
This issue concerns the character of the income that included under Treas. Reg. § 1.1502-19 from the excess loss account (ELA) with respect to the stock



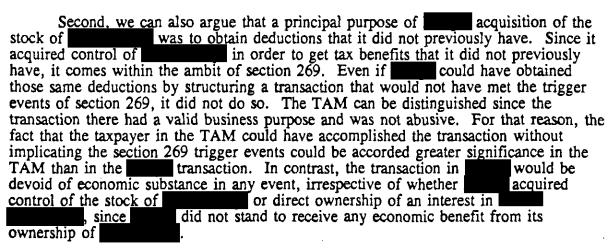
. We understand this computation was prepared by for settlement purposes and that is willing to agree to an insolvency of \$. as part of a settlement. The question of second 's insolvency is a factual, economic determination involving a comparison of its liabilities (as described in Treas. Reg. § 1.1502-19(a)(ii)) against the fair market value of its assets. Whether the \$ _____ figure in calculation approximates the figure that would be produced if liabilities were subtracted from assets is a question we cannot answer without more facts. However, it appears that is willing to concede the higher \$ insolvency amount. If you do not believe that a comparison of assets and liabilities would necessarily show a greater (or lesser) figure than has agreed to concede, perhaps concession on this issue should be accepted. If you do obtain the asset and liability figures necessary to make the insolvency calculation, we will be glad to give you our comments on what the level of insolvency is. Furthermore, if we can be of any assistance to you in working with taxpayer to develop the assets and liabilities data, should you choose to pursue this, we will be glad to help. II. Section 269 Issue You propose to assert that section 269 precludes from using 's allocable share of the losses generated by You believe that the acquisition by the consolidated group of control of the stock of was principally for the purpose of obtaining the above partnership deductions and had no other economic effect. That is, as soon as the group used up the losses, it stock back to for nominal consideration, pursuant to prior agreement. The group, in effect, paid about \$ for the use of approximately \$ for the use of partnership deductions. It is claims that it had a business purpose because it was a contractor working on the construction of the building partnership constructing the building prevented termination of the building project and, in turn, protected its business interests as a major contractor on the project. The \$ million that contributed, however, was a payment for using the partnership deductions by acquiring the stock of You have asked us whether this section 269 argument can be maintained, especially in light of Technical Advice Memorandum (TAM) 9134003 (May 6, 1991). The TAM states, in part, that one factor establishing that section 269 does not apply in that case is the determination that the acquisition of a partnership interest could just as easily have yielded the same desired tax benefits as the acquisition of control of a corporation. argues that this TAM supports the nonapplicability of section 269 in this case because it could have obtained the same tax benefits it obtained from by acquiring instead a partnership interest in

We have a number of comments on this issue. First, we recommend that you consider making a non-section 269 attack on use of the partnership deductions. In J.D. & A.B. Spreckels Co. v. Commissioner, 41 BTA 370 (1940), the Board of Tax Appeals held that a corporation was not a member of an affiliated group because the

taxpayer's ownership of the corporation's stock did not serve a business purpose, as distinguished from a tax-reducing purpose. We suggest that you determine whether the facts in the instant case are sufficiently close to those in *Spreckels* to come within the rationale of that case, which if applicable would preclude the group from using the partnership deductions.



We believe the following arguments can be made under the language of section 269. First, depending on the facts, we could argue that practical difficulties would have made it impossible to utilize a partnership to obtain the same tax benefits. We do not have sufficient facts to determine the correctness of taxpayer's assertion that it could have obtained the same tax benefits by acquiring a partnership interest rather than control of You may wish to request that taxpayer provide the details and supporting facts to justify its assertion. If you need our assistance in dealing with taxpayer on this matter, we will be glad to help. Once you have obtained these details, we would also be happy to give you our comments on taxpayer's assertion at that time.



For similar reasons, we believe that the Action on Decision (AOD) acquiescing in Cromwell Corp. v. Commissioner, 43 T.C. 313 (1964), is also distinguishable. In Cromwell, the Service denied the privilege of filing a consolidated return based on section 269, arguing that the formation of Cromwell and its subsequent acquisition of an operating company were for the principal purpose of securing a tax benefit which could not otherwise have been obtained. The benefit at issue was the exclusion of a dividend

from the operating company to Cromwell, which Cromwell then used to pay off a bank loan obtained to purchase the operating company. In effect, the dividend exclusion within the consolidated group allowed Cromwell to use the operating company's assets to finance the acquisition. Finding that the same benefit could have been obtained by using alternative methods, the Tax Court held that section 269 was inapplicable. In recommending acquiescence, the *Cromwell* AOD states that "the issue is in part factual . . . and the Court's application of the narrow statutory phrase involved is reasonable." (A copy of the AOD is attached.)

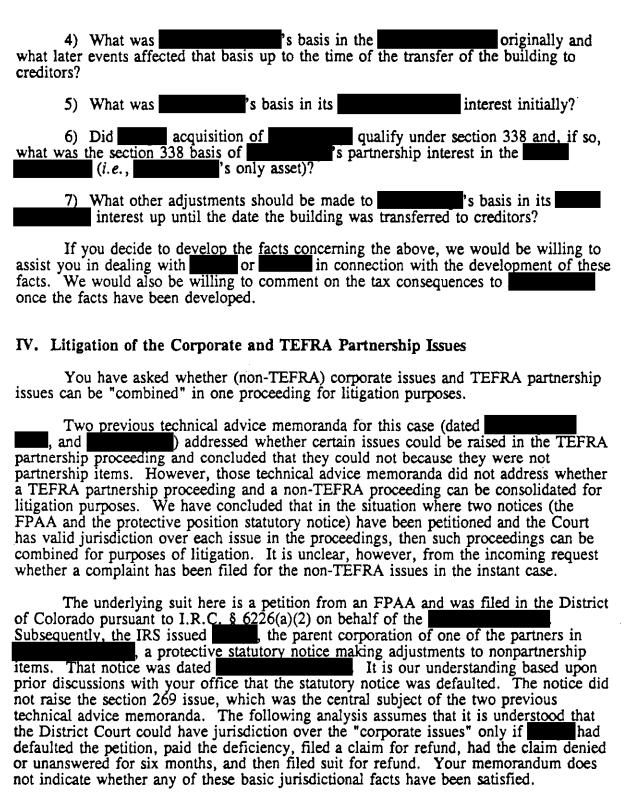
Although not expressly noted in the AOD, the Tax Court observed that "the basic purpose of section is to prevent the distortion of a taxpayer's net income" and that there was no distortion of income in this case. 43 T.C. at 320. The court further distinguished the transaction in *Cromwell* from "the usual section 269 situation where a taxpayer is attempting to secure the benefit of built-in tax advantages, typically a net operating loss carryover, by combining two corporations via an acquisition." *Id.* Thus, as in the TAM, there was not the abuse that exists in the instant case.

III. Programme of the Business

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			ve that may have been
incorrect and could have			of insolvency of
at the time its sto	ck was sold by	to trig	gering the ELA.

You have asked if we have any comments on this matter. We do not have sufficient facts to be able to provide any meaningful comments. However, you may wish to request from and/or and/or a detailed computation plus supporting facts showing whether and to what extent, if any, and the sufficient facts of its building to creditors. Matters that could be relevant to this computation are:

- 1) What were the original contributions to
- 2) What later events affected shall so basis in the building or its amount realized at the time of the transfer of the building to creditors?
- 3) What was state is basis in its partnership interest in originally and up to the time it transferred its partnership interest to



As stated in the earlier technical advice memoranda, only partnership items can be addressed in a partnership proceeding. The court's jurisdiction to determine partnership adjustments derives from section 6226, while the court's jurisdiction for

determining non-TEFRA adjustments falls under the subchapter B procedures. Thus, TEFRA partnership issues and non-TEFRA corporate issues cannot be combined based solely upon the filing of the petition from the notice of FPAA and a defaulted statutory notice.

Your incoming request suggests that our conclusion regarding whether non-TEFRA issues can be raised in a TEFRA proceeding may be different if we consider the fact that all the partners in the TEFRA proceeding are parties to the suit. That fact has no impact on our conclusion. The issue here is whether the court has jurisdiction over non-TEFRA issues in a TEFRA proceeding based upon a notice of FPAA. The fact that the parties to the partnership proceeding would be the same parties in the non-TEFRA proceeding does not bestow jurisdiction upon the court for the non-TEFRA issues. If the only complaint filed is based upon the notice of FPAA, the court has jurisdiction only over the partnership items and does not have jurisdiction over the nonpartnership items.

On the other hand, if two separate complaints have been filed — one based upon a denial of a claim for refund and the other based upon the notice of FPAA — the court validly has jurisdiction over all of the issues in these separate respective proceedings. Because the court has jurisdiction over each, we see no reason why the two separate proceedings could not be combined for purposes of litigation (i.e., trial), particularly since the same parties are involved and the issues arise from the same facts and transactions.

Based upon facts in the earlier technical advice memoranda, it does not appear that has petitioned the court from the protective position statutory notice. If had petitioned, then no consolidation could take place because this petition would have been in the Tax Court.

If a complaint has been filed or is later filed in the District Court, then consolidation may be possible for the issues raised in that notice. However, it is unlikely that consolidation could occur for the section 269 issue. Since that issue is an affected item, the partnership proceeding probably must be completed before it can be litigated. Furthermore, the issue is not before the court even if a complaint based upon the defaulted statutory notice has been filed because the section 269 issue was not raised in that notice and no tax on this issue can possibly have been paid yet, much less refunded.

We want to emphasize that it is the fact that valid petitions have been filed for the TEFRA and non-TEFRA issues which allows for the consolidation, and not the fact that all the partners in the TEFRA proceeding are parties to the suit. In the previous technical advice memoranda for this case, we looked at the possibility of raising non-TEFRA issues in a TEFRA partnership proceeding, not at consolidating two proceedings where the court has jurisdiction over the issues. The Tax Court has held that partnership items and nonpartnership, or affected, items cannot be raised in the same proceeding. See Trost v. Commissioner, 95 T.C. 560 (1990); N.C.F. Energy v. Commissioner, 89 T.C. 741 (1987); Maxwell v. Commissioner, 87 T.C. 783 (1986); Farris v. Commissioner, T.C. Memo. 1986-567. However, these cases have involved the situation where only one notice, either an FPAA or a statutory notice, was issued and petitioned. They do not involve the situation where an FPAA and statutory notice

were issued and both petitioned, and taxpayers were attempting to consolidate for purposes of trial.

If you have any further questions, please call Gerald Fleming at FTS 566-3335 concerning issues I through III, or Marsha Keyes at FTS 566-4174 concerning issue IV.

DANIEL J. WILES

Bv:

ALFRED C. BISHOP, JR Chief, Corporate Branch Field Service Division

Attachment: Cromwell AOD

This document may include confidential information subject to the attorney-client and deliberative process privileges, and may also have been prepared in anticipation of litigation. This document should not be disclosed to anyone outside the IRS, including the taxpayer(s) involved, and its use within the IRS should be limited to those with a need to review the document in relation to the subject matter or case discussed herein.

This document also is tax information of the instant taxpayer which is subject to I.R.C. § 6103.